Management's Discussion and Analysis of Financial Conditions and Results of Operations

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Summary

The Group's operating revenues in 2009 were RMB209,370 million, an increase of 12.2%[1] from 2008; operating expenses were RMB186,712 million, an increase of 2.9% from 2008; profit attributable to equity holders of the Company was RMB14,422 million and basic earnings per share was RMB0.18; EBITDA[2] was RMB83,284 million and the EBITDA margin was 39.8%.

Excluding the amortisation of upfront connection fees, the operating revenues of the Group in 2009 were RMB208,219 million, an increase of 12.9% from 2008; profit attributable to equity holders of the Company was RMB13,271 million, a decrease of 33.9%[3] from 2008, basic earnings per share was RMB0.16; EBITDA was RMB82,133 million and the EBITDA margin was 39.4%.

Operating Revenues

In 2009, the Group actively coped with the global financial crisis as well as increasingly intense market competition, and continued to adhere to the customer branding operation. Through vigorously promoting strategic transformation, the full services operation has a remarkable start. Operating revenues in 2009 were RMB209,370 million, an increase of 12.2% from 2008. Excluding the amortisation of upfront connection fees of RMB1,151 million, operating revenues in 2009 were RMB208,219 million, an increase of 12.9% from 2008. Of this, the total mobile revenue was RMB35,620 million (including mobile voice revenue of RMB20,027 million, revenue of RMB9,976 million from mobile Internet access, value-added and integrated information application services as well as leased line services and other mobile services revenue of RMB5,617 million), maintaining a satisfactory growth momentum. The ratio of wireline non-voice services to total revenue from wireline services, excluding the amortisation of upfront connection fees, has increased over the year to 54.6% in 2009, a rise of 8.6 percentage points from 2008. With the sustainable development of our wireline non-voice services, the Group's revenue structure has become more optimised and the risk of over-reliance on traditional businesses has been further reduced, enhancing the Group's capacity in risk management.

1 *According to the "IFRIC 13 Customer Loyalty Programmes", operating revenues, selling, general and administrative expenses, as well as other operating expenses for 2008 were adjusted. Please refer to note 3 of the audited financial statements for details.*

2 *EBITDA is calculated from operating revenues minus operating expenses (which excluded depreciation and amortisation and CDMA network capacity lease fee). As the telecommunications business is a capital intensive industry, capital expenditure, the level of gearing and finance costs may have a significant impact on the net profit of companies with similar operating results. Therefore, we believe EBITDA may be helpful in analysing the operating results of a telecommunications service provider such as the Company. Although EBITDA has been widely applied in the global telecommunications industry as a benchmark to reflect operating performance, financial capability and liquidity, it is not regarded as a measure of operating performance and liquidity under generally accepted accounting principles. It also does not represent net cash from operating activities. In addition, our EBITDA may not be comparable to similar indicators provided by other companies.*

3 *Excluding the one-off items of the asset impairment loss of PHS assets of RMB18,366 million (after-tax effect) and the losses related to natural disasters of RMB2,838 million (after-tax effect), profit attributable to equity holders of the Company in 2008 was RMB20,066 million.*

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The following table sets forth a breakdown of the operating revenues of the Group for 2008 and 2009, together with their respective rates of change:

(RMB in millions, except percentage data)	For the year ended 31 December		
	2009	2008	Rates of Change
Wireline voice	**78,432**	96,258	(18.5%)
Mobile voice	**20,027**	3,955	406.4%
Internet	**51,567**	40,727	26.6%
Value-added services	**21,533**	16,253	32.5%
Integrated information application services	**12,659**	10,803	17.2%
Managed data and leased line	**11,499**	10,231	12.4%
Others	**12,502**	6,280	99.1%
Upfront connection fees	**1,151**	2,022	(43.1%)
Total operating revenues	**209,370**	186,529	12.2%

Wireline Voice

In 2009, revenue from wireline voice services was RMB78,432 million, a decrease of 18.5% from RMB96,258 million in 2008, accounting for 37.5% of our operating revenues. The major reason for the continuous decline in the wireline voice revenue was due to the lower demand for telecommunications services under the global financial crisis and the cannibalisation of wireline voice usage with newer forms of communication, such as mobile communications and VOIP.

Mobile Voice

In 2009, revenue from mobile voice services was RMB20,027 million, accounting for 9.6% of our operating revenues. With the launch of full services operation, the mobile services have gained momentum of development and have become one of the main revenue drivers.

Internet

In 2009, revenue from Internet access services was RMB51,567 million, an increase of 26.6% from RMB40,727 million in 2008, accounting for 24.6% of our operating revenues. Through integrated operations, the revenue from our Internet access services has grown rapidly with the continual increase in broadband subscribers. At the end of 2009, the number of wireline broadband subscribers increased by 20.8% to 53.46 million, with a net increase of 9.19 million subscribers from the end of 2008. The ARPU of the wireline broadband subscribers in 2009 was RMB80.3. Revenue from mobile Internet access services was RMB3,760 million.

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Value-Added Services

In 2009, revenue from value-added services was RMB21,533 million, an increase of 32.5% from RMB16,253 million in 2008, accounting for 10.3% of our operating revenues. The increase in revenue was mainly attributable to the rapid development of mobile value-added services and the IDC business of wireline value-added services. Revenue from mobile value-added services was RMB5,602 million.

Integrated Information Application Services

In 2009, revenue from integrated information application services was RMB12,659 million, an increase of 17.2% from RMB10,803 million in 2008, accounting for 6.0% of our operating revenues. The increase in revenue was mainly due to the rapid development of the IT service and applications services, "Best Tone" type of information services and "V-Net" services. Revenue from mobile integrated information application services was RMB607 million.

Managed Data and Leased Line

In 2009, revenue from managed data and leased line services was RMB11,499 million, an increase of 12.4% from RMB10,231 million in 2008, accounting for 5.5% of our operating revenues. The increase in revenue was mainly attributable to the increasing demand from non-operator customers for network resources, leading to increased revenue growth from the leased circuits services and IP-VPN services.

Others

In 2009, revenue from other services was RMB12,502 million, an increase of 99.1% from RMB6,280 million in 2008, accounting for 6.0% of our operating revenues. The growth of revenue was mainly attributable to the sales revenue of mobile terminal equipments. Revenue from other mobile services was RMB5,617 million.

Upfront Connection Fees

Upfront connection fees represent the amortised amount of upfront fees received for the initial activation of wireline services of the Group, amortised over an expected customer relationship period of 10 years. Effective from July 2001, the Group ceased to charge new subscribers upfront connection fees. The amortised amount was RMB1,151 million in 2009, representing a decrease of 43.1% from RMB2,022 million in 2008.

The amortisation of upfront connection fees will end in July 2011. The amortised upfront connection fees for the year 2010 and 2011 will be RMB497 million and RMB98 million respectively.

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Operating Expenses

In 2009, the operating expenses of the Group were RMB186,712 million, an increase of 2.9% from 2008. The ratio of operating expenses to operating revenues fell from 97.2% in 2008 to 89.2% in 2009. The Group has stringent cost control measures to continuously optimise the costs structure and increased investment in mobile services and transformation services in order to support the full services operation so as to ensure the sustainable and healthy development.

The following table sets out a breakdown of the operating expenses of the Group in 2008 and 2009 and their respective rates of change:

	For the year ended 31 December		
(RMB in millions, except percentage data)	**2009**	2008	Rates of Change
Depreciation and amortisation	**52,243**	53,880	(3.0%)
Network operations and support expenses	**42,903**	36,096	18.9%
Selling, general and administrative expenses	**40,507**	27,501	47.3%
Personnel expenses	**32,857**	28,946	13.5%
Other operating expenses	**17,449**	10,794	61.7%
Impairment loss on property, plant and equipment	**753**	24,167	(96.9%)
Total operating expenses	**186,712**	181,384	2.9%

Depreciation and Amortisation

In 2009, depreciation and amortisation was RMB52,243 million, a decrease of 3.0% from RMB53,880 million in 2008, accounting for 25.0% of our operating revenues. The decline was due to the impairment loss of PHS assets in 2008 and the reduction of capital expenditure by the Group.

Network Operations and Support Expenses

In 2009, network operations and support expenses were RMB42,903 million, an increase of 18.9% from RMB36,096 million in 2008, accounting for 20.5% of our operating revenues. The increase was mainly attributable to the increase in CDMA network capacity lease fee and an increased investment in transformation services by the Group. The CDMA network capacity lease fee in 2009 amounted to RMB8,383 million.

Selling, General and Administrative Expenses

In 2009, selling, general and administrative expenses amounted to RMB40,507 million, an increase of 47.3% from RMB27,501 million in 2008, accounting for 19.3% of our operating revenues. The growth was mainly attributable to an increased investment in resources to reinforce the rapid scale development of the mobile services.

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Personnel Expenses

In 2009, personnel expenses were RMB32,857 million, an increase of 13.5% from RMB28,946 million in 2008, accounting for 15.7% of our operating revenues. The increase in personnel expenses was mainly due to the inclusion of annual personnel expenses of employees from China Unicom Group for the whole year of 2009 (the figures of 2008 represented the expenses for the fourth quarter only) as well as the recruitment of talents with high-calibre in mobile communications, IP, IT and information operations areas to meet the requirement to develop full services operation.

Other Operating Expenses

In 2009, other operating expenses were RMB17,449 million, an increase of 61.7% from RMB10,794 million in 2008, accounting for 8.3% of our operating revenues. The increase was largely attributed to the growth in the mobile interconnection expenses and cost of mobile terminal equipments sold. The mobile interconnection expenses amounted to RMB3,467 million in 2009, while the cost of mobile terminal equipments sold were RMB4,980 million.

Impairment loss on Property, Plant and Equipment

In 2009, the impairment loss on property, plant and equipment was RMB753 million, which was mainly due to the decrease in customer demand for Digital Data Network (DDN) service and its technology being gradually substituted by other technologies, resulting in the significant decrease in the revenue generated from these assets. As a result, the Group recognised an impairment loss on these assets. In 2008, the Group had recognised an impairment loss of RMB23,954 million on PHS assets.

Net Finance Costs

In 2009, the Group's net finance costs were RMB4,375 million, a decline of 13.8% from RMB5,076 million in 2008. Benefited from the reduction of interest rates by the People's Bank of China at the end of 2008 and our low-cost financing in 2008, net interest expenses fell by RMB612 million. In addition, the Group optimised its financing by reinforcing its centralised capital management, leading to a reduction in finance costs. Net exchange gains were RMB67 million in 2009, while net exchange losses were RMB170 million in 2008. The change in net exchange gain/loss was mainly attributable to the appreciation of the RMB against the Japanese Yen.

Profitability Level

Income Tax

The Group's statutory income tax rate is 25%. In 2009, the Group's income tax expenses were RMB4,549 million, with the effective income tax rate of 23.7%. The difference between the effective income tax rate and the statutory income tax rate of the Group was mainly attributable to the exclusion of upfront connection fees from taxable revenue, and the preferential income tax rate of 20% or 15% enjoyed by our branches located in special economic zones and the western regions of China.

Profit Attributable To Equity Holders of the Company

In 2009, profit attributable to equity holders of the Company was RMB14,422 million, an increase of RMB13,538 million from RMB884 million in 2008. Excluding the amortisation of upfront connection fees, the profit attributable to equity holders of the Company was RMB13,271 million, a decrease of 33.9% from RMB20,066 million (excluding the impact of one-off items including PHS assets impairment loss with after-tax effect of RMB18,366 million and natural disasters with after-tax effect of RMB2,838 million) in 2008.

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Capital Expenditure and Cash Flows

Capital Expenditure

In 2009, the Group maintained its prudent policy on capital expenditure. Capital expenditure was RMB38,042 million, a decrease of 21.4% from RMB48,410 million in 2008.

Cash Flows

In 2009, net cash inflow for the Group was RMB6,940 million, while the net cash inflow was RMB6,522 million in 2008.

The following table sets out the cash flow position of the Group in 2008 and 2009:

	For the year ended 31 December	
(RMB millions)	**2009**	2008
Net cash flow from operating activities	**74,988**	76,756
Net cash used in investing activities	**(43,255)**	(75,819)
Net cash (used in)/from financing activities	**(24,793)**	5,585
Net increase in cash and cash equivalents	**6,940**	6,522

In 2009, the net cash inflow from operating activities was RMB74,988 million, a decrease of RMB1,768 million from RMB76,756 million in 2008.

In 2009, the net cash outflow for investing activities was RMB43,255 million, a decrease of RMB32,564 million from RMB75,819 million in 2008, mainly resulting from a reduction in the Group's capital expenditure in 2009 and the payment of most of the consideration for the acquisition of the CDMA business from China Unicom Group in 2008.

In 2009, the net cash outflow for financing activities was RMB24,793 million while the net cash inflow was RMB5,585 million in 2008. The increase in net cash outflow was mainly due to the Group's repayment of the remaining balance of the deferred consideration in respect of the acquisition in prior years totalling RMB15,150 million to China Telecommunications Corporation and short-term commercial papers totalling RMB10,000 million.

Working Capital

At the end of 2009, the Group's working capital (total current assets minus total current liabilities) deficit was RMB82,545 million, a reduction of deficit of RMB38,746 million from RMB121,291 million in 2008. The decrease in deficit was mainly attributable to the issuance of medium-term notes, amounting to RMB30,000 million, net off by the repayment of short-term debt including short-term commercial papers. At the end of 2009, the Group's cash and cash equivalents amounted to RMB34,804 million, amongst which cash and cash equivalents in RMB accounted for 94.7% (2008: 94.2%).

Assets and Liabilities

In 2009, the Group continued to maintain a solid capital structure. By the end of 2009, the total assets of the Group fell to RMB426,520 million from RMB440,337 million at the end of 2008, while total indebtedness decreased to RMB105,923 million from RMB123,279 million in 2008. The ratio of the Group's total indebtedness to total assets fell from 28.0% at the end of 2008 to 24.8% at the end of 2009.

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Indebtedness

The indebtedness analysis of the Group as of the end of 2008 and 2009 is as follows:

	For the year ended 31 December	
(RMB millions)	**2009**	2008
Short-term debt	**51,650**	83,448
Long-term debt maturing within one year	**1,487**	565
Finance lease obligations maturing within one year	**18**	22
Long-term debt (excluding current portion)	**52,768**	39,226
Finance lease obligations (excluding current portion)	**—**	18
Total debt	**105,923**	123,279

By the end of 2009, the total indebtedness of the Group was RMB105,923 million, a decrease of RMB17,356 million from 2008. The main reason for the decrease was our repayment of the remaining balance of the deferred consideration in respect of the acquisition in prior years to China Telecommunications Corporation. Of the total indebtedness of the Group, the Company's loans in Renminbi, US Dollars, Japanese Yen and Euro accounted for 96.9% (2008: 97.2%), 0.8% (2008: 0.7%), 1.7% (2008: 1.5%), and 0.6% (2008: 0.6%) respectively. 95.7% (2008: 87.2%) of this indebtedness was loans with fixed interest rates, while the remainder are loans with floating interest rates. As of 31 December 2009, the Group did not pledge any assets as collateral for debt (2008: Nil).

Most of the Group's revenue receipts from and payments made for its business were denominated in Renminbi, therefore the Group did not have significant risk exposure to foreign exchange fluctuations.

As at 31 December 2009, the Group's unutilised committed credit facilities was RMB102,555 million (2008: RMB128,231 million).

Contractual Obligations

		Payable in				
(RMB millions)	Total	1 Jan 2010- 31 Dec 2010	1 Jan 2011- 31 Dec 2011	1 Jan 2012- 31 Dec 2012	1 Jan 2013- 31 Dec 2013	Thereafter
Short-term debt	52,294	52,294	—	—	—	—
Long-term debt	62,764	3,742	12,260	13,126	11,353	22,283
Finance lease obligations	18	18	—	—	—	—
Operating lease commitments	11,110	8,531	643	505	417	1,014
Capital commitments	4,542	4,542	—	—	—	—
Total contractual obligations	130,728	69,127	12,903	13,631	11,770	23,297

Note: Amounts of short-term debt, long-term debt and finance lease obligations include recognised and unrecognised interest payable, and are not discounted.


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"One Home" packaged services for household customers:

32% penetration

(⇧ 12ppt)

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50% penetration

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